Internal Revenue Service
memorandum

CC:INTL-0021-89
Brl:WEWilliams

date: JAN 23 1989

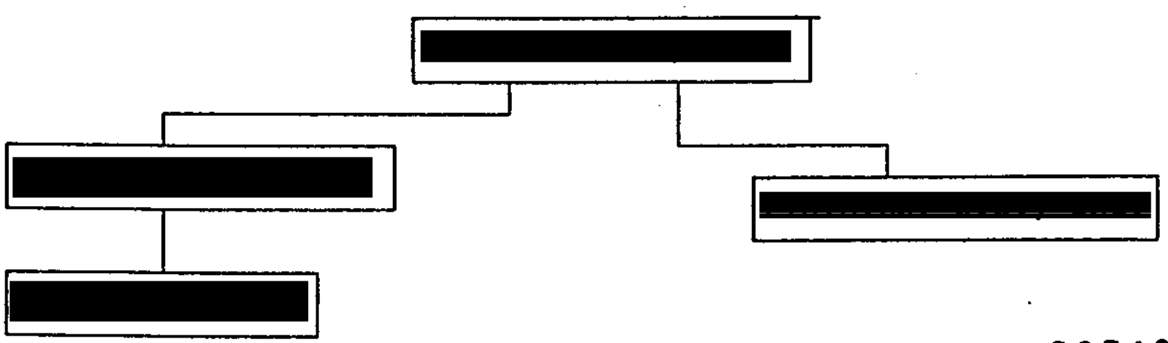
to: District Counsel, Miami CC:MIA
Attn: Mr. Garcia-Pages

from: Senior Technician Reviewer, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: [redacted]

This refers to your memorandum dated December 19, 1988, in which you request our advice concerning the I.R.C. § 482 and debt versus equity issues that have been raised by the revenue agent in this case. In particular, you ask for our comments on the advice that your office gave to the District Director by memorandum dated November 2, 1988.

As we understand them, the facts are as follows. Prior to a reorganization on [redacted], a German corporation, [redacted], owned [redacted] percent of the stock of a U.S. corporation, [redacted]; [redacted] also owned [redacted] percent of the stock of a Canadian corporation, [redacted], that did business in the U.S. through a branch, [redacted]. After the reorganization, [redacted] was incorporated as a domestic corporation, [redacted], wholly owned by [redacted]. The corporate structure prior to the reorganization was as follows:



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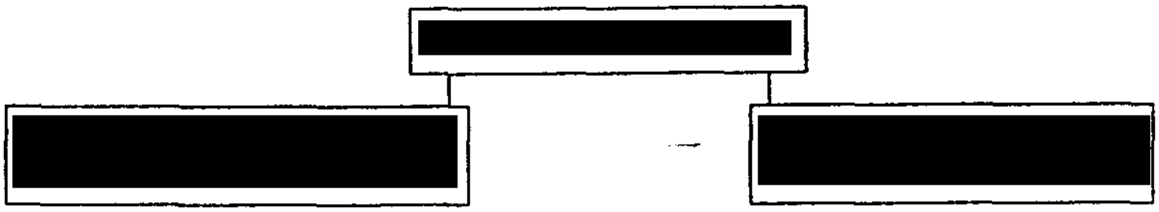
The corporate structure after the reorganization was as follows:



[redacted] built condominium developments in [redacted], Florida, known as [redacted] before the reorganization. It sold land to [redacted] on [redacted], on which [redacted] built [redacted] of [redacted] during [redacted]. The IRS has determined that the sale of the land in [redacted] was at a fair market price. During [redacted], the condominium market in Florida became depressed, and a market study commissioned by the taxpayers indicated that it would remain depressed through at least [redacted]. The study recommended that the condominiums in [redacted], that had not been sold by [redacted], be inventoried. As inventory, the unsold [redacted] condominiums produced substantial operating losses for [redacted]. However, [redacted] had already accumulated large net operating losses and could not utilize the losses attributable to the [redacted] condominiums. [redacted], on the other hand, had paid substantial amounts of income tax in previous years on income attributable to sales of the condominiums in [redacted].

On [redacted], [redacted] sold [redacted] of [redacted] to [redacted] for $[redacted], an amount that the IRS has determined was a fair market price.[1]/ [redacted] realized a gain on this sale ($[redacted]) which it offset against the net operating losses that it had accumulated from prior years ($[redacted]), and no tax liability was incurred on the gain. [redacted] operated the condominiums at net losses of $[redacted], $[redacted], and $[redacted] for [redacted], [redacted], and [redacted] respectively. [redacted]s net operating losses attributable to operation of [redacted] were computed as follows:

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[1]/ This sale price included a purchase money note to [redacted] in the amount of $[redacted] that bore interest at [redacted]% per annum and that became due on [redacted]. Principal payments were made on the note in [redacted] and [redacted] in the respective amounts of $[redacted] and $[redacted].

	[redacted]	[redacted]	[redacted]
Interest paid to [redacted]	$[redacted]	$[redacted]	$[redacted]
Interest paid to parent[2]/	[redacted]	[redacted]	[redacted]
Cost of sales[3]/	[redacted]		
Miscellaneous expenses, etc.	[redacted]	[redacted]	[redacted]
Total losses of [redacted]	$[redacted]	$[redacted]	$[redacted]

The revenue agent has proposed alternative positions, both of which essentially sham the sale of [redacted] by [redacted] to [redacted]. The agent's primary position is disallowance of [redacted]s deduction of the interest paid to [redacted], the interest paid to the German parent, and the costs of sales; and to allocate the balance of the expenses, under section 482, to [redacted]. The agent's alternative position is to allocate [redacted]s total losses to [redacted] under section 482.

While recognizing the litigating hazards in the agent's positions, your office has generally approved the use of section 482 to reallocate all or part of [redacted]'s losses to [redacted]. Your memorandum concludes that the sale of [redacted] from [redacted] to [redacted] was primarily tax motivated and rejects the taxpayer's asserted business reasons for the sale. Relying principally on <u>Ballentine Motor Co. v. Commissioner</u>, 39 T.C. 348 (1962), <u>aff'd</u> 321 F.2d 796 (4th Cir. 1963), you conclude that the IRS may be able to defend the section 482 allocation in this case. However, you also recognize that there is the clear possibility that a court could find that the sale falls within the category of legitimate tax planning.

<u>I.R.C. § 482 issue</u>

I.R.C. § 482 authorizes the Commissioner in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such allocation is

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[2]/ [redacted] advanced funds to [redacted] to enable the latter meet interest and principal payments on the purchase money note to [redacted].

[3]/ These are the costs of sales of condominiums that would have been claimed as deductions by [redacted] if it had not sold the property. The costs of sales actually incurred by [redacted] have been adjusted to reflect what the costs would have been if there had not been an increase in basis as a result of the sale.

necessary in order to prevent the evasion of taxes or clearly to reflect the income of the organizations, trades, or businesses. An arm's length standard is utilized in determining a controlled taxpayer's true taxable income. See Treas. Reg. § 1.482-1(a)(6), and E. I. DuPont de Nemours and Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979), cert. denied, 445 U.S. 962 (1980). In Hamburgers York Road, Inc. v. Commissioner, 41 T.C. 821, 833 (1964), acq. 1965-2 C.B. 5, the Tax Court stated as follows:

> The purpose of said statute is to prevent the evasion of taxes by the shifting of profits, the making of fictitious sales, and other methods customarily used to "milk" a taxable entity. H. Rept. No. 2, 70th Cong., 1st Sess. pp. 16-17, reprinted in 1939-1 C.B. (Part 2) 395; S. Rept. No. 960, 70th Cong., 1st Sess. p. 24, reprinted in 1939-1 C.B. (Part 2) 426; Ballentine Motor Co., 39 T.C. 348, 357, affd. 321 F.2d 796 (C.A. 4).

In Marc's Big Boy-Prospect, Inc. v. Commissioner, 52 T.C. 1073 (1969), aff'd 452 F.2d 137 (7th Cir. 1971), the Tax Court, at page 1093, observed that

> [t]he Commissioner may allocate income and deductions between commonly controlled corporations not because the common owner has the power to shift income but only where there has been actual shifting of income or deductions. [Citations omitted.] Otherwise the provision would "punish the mere existence of common control or ownership" rather than "assist in preventing distortion of income and evasion of taxes through the exercise of that control or ownership." [Citations omitted.]

An allocation made by the Commissioner under section 482 is presumptively correct and must be sustained, unless the taxpayer can show that the allocation is arbitrary, unreasonable, capricious, or an abuse of discretion. Wisconsin Big Boy Corp. v. Commissioner, 452 F.2d 137 (7th Cir. 1971); and Philipp Brothers Chemicals, Inc. v. Commissioner, 435 F.2d 53 (2d Cir. 1970).

Section 1.482-2(e)(1)(i) of the Regulations states that in the case of a sale of tangible property between members of a commonly-controlled group and at other than an arm's length price, "the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition."

The IRS has been successful in allocating income under section 482 between commonly-controlled corporations where the facts were somewhat similar to those in this case and where the court has found the taxpayer's arrangement to have been other than at arm's length and primarily tax motivated. In Ballentine Motor Co. v. Commissioner, 39 T.C. 348 (1962), aff'd 321 F.2d 796 (4th Cir. 1963), an individual, Mr. Ballentine, and his family owned all of the stock of four corporations that operated used car lots in various locations in South Carolina and Georgia. The car lot in Atlanta proved to be unprofitable and by December 31, 1953, the corporation that owned this lot, Ballentine Motors of Georgia, Inc. (hereinafter "Georgia, Inc."), had accumulated operating deficits of $59,919.97 and owed $60,000 to a financing entity, Motor Investment Co., that was also controlled by Mr. Ballentine.

In 1954, Mr. Ballentine caused Georgia, Inc. to purchase the entire inventory of another of his used car lot corporations, a profitable operation. The inventory had a book value of $54,367.31. The sale was effected by the financing company loaning Georgia, Inc. $70,000; Georgia, Inc. issuing a check to the seller for $54,367.31; and the seller transferring the sale proceeds to the finance company as a credit. No change was made in the personnel or operation of the acquired used car lot. Approximately a month later, Georgia, Inc. acquired the inventory of another profitable used car lot corporation in the Ballentine group under the same circumstances. As was the case with the first transfer, no change was made in the personnel or operation of the acquired used car lot. The only difference was that the income and expenses of the acquired lots was recorded on the books of Georgia, Inc. It was this net income that the IRS determined should be reallocated, under section 482, from Georgia, Inc. to the two selling corporations.

The Tax Court found that the inventories were sold at fair market prices; the court, however, at page 359, treated the ultimate issue as whether, factually, the inventory sales were bona fide. The Court noted that for the taxable year in which the inventory transfers occurred (1954), Georgia, Inc. realized net income from the two acquired lots in the amount of $65,647.34 and that Georgia, Inc.'s previous losses offset all but $5,727.34 of this income; that at the end of 1954, when Georgia, Inc.'s losses were used up, the acquired lots were transferred to other Ballentine corporations; and that the purported inventory sales were only evident on Georgia, Inc.'s books and not in the operation of either of the car lots. The court in concluding that the "sole" purpose of the transfer of the inventories was to make use of Georgia, Inc.'s net operating loss carryover observed, at page 360, that

> the temporary shift in the title to the income-producing assets seems to be but a flagrant attempt to make use of Georgia's net operating loss carryover....The otherwise unexplained retransfer of these inventories on January 1, 1955, can only indicate

> that the overall plan from the beginning had been an arbitrary shifting of income among controlled businesses. [Footnote omitted.]

A similar result was reached in Spicer Theatre, Inc., et al. v. Commissioner, 44 T.C. 198 (1964), aff'd 346 F.2d 704 (6th Cir. 1965). In this case, two commonly-controlled corporations, Copley Theatre, Inc. and Spicer Theatre, Inc., operated an indoor movie theater and two drive-in theaters, respectively. By the end of its taxable year ended January 31, 1954, Copley, Inc. had accumulated a net operating loss of $79,853.25, largely from sale of its theater at a substantial loss; on the other hand, the drive-in theaters operated by Spicer, Inc. were, profitable.

On May 1, 1957, Spicer, Inc. and Copley, Inc. executed a "Lease Agreement" pursuant to which the former leased the two drive-ins to the latter for a period of two years at a rental of $48,000 per year. The drive-ins were operated by Copley, Inc. in the same manner and with the same employees as they had been by Spicer, Inc. The difference was that the income and costs of operation of the drive-ins were recorded on the books of Copley, Inc. which had no other income or deductions. Prior to applying its net operating loss carryover, Copley, Inc.'s taxable income for years ended January 31, 1958 and January 31, 1959, was $36,084.82 and $6,444.77; this income was completely eliminated by the loss carryover. The IRS determined that the items of income and deductions reported by Copley, Inc. from operation of the drive-ins should be allocated, under the authority of section 482, from Copley, Inc. to Spicer, Inc. for taxable years ended January 31, 1958 and January 31, 1959.

In upholding the IRS's determination, the Tax Court, essentially holding that the lease was not bona fide, concluded, at page 206, that

> there was no business purpose for the lease except the reduction of the total tax liability of Spicer and Copley by providing Copley with sufficient income from operation of the theaters theretofore operated by Spicer to enable it to use its net operating loss carryover. The lack of any purpose for a transaction other than tax avoidance strongly indicates that the overall plan was an arbitrary shifting of income among controlled businesses primarily for evasion of taxes justifying the Commissioner in making an attribution of the income and deductions to the party whose activities generated the income. Ballentine Motor Co., supra.

While stating that the evidence was insufficient to establish that the rental of $48,000 per year was arm's-length consideration, the court, at page 207 and relying on Ballentine

Motor Co., observed that even a fair market rental would not establish that the lease was bona fide. A critical factor in the court's conclusion was its finding that the amount of rental payments was arrived at by the taxpayers in order to absorb Copley, Inc.'s net operating loss carryover by the end of the two-year lease term.[4]/ As in Ballentine Motor Co., the transfer of the income producing property was temporary and was essentially for the period necessary to absorb the transferee's prior losses.

In this case there is no evidence that there has been a retransfer of the [redacted] property by [redacted] to [redacted] or that [redacted] has not realized taxable income from sales of condominiums (as reflected in [redacted]'s cost of sales increasing from [redacted] in [redacted] to $[redacted] in [redacted]). Therefore, we think that it is unlikely that the IRS would be able to establish that the sale here was not bona fide and was completed for the purpose of creating operating losses for [redacted] that could be carried back to the years in which it had taxable income. In this regard, the taxpayers will argue that the purposes for the sale were as follows:

(1) To separate the developmental activities from the management activities by placing the development in one corporation and the management activities in another corporation;

(2) To consolidate all claims arising out of the construction of [redacted], and [redacted] in one corporation; and

(3) To separate the commercial real property from the residential real property by placing the commercial real property in one corporation and the residential real property in another corporation.

While we cannot evaluate the validity of these claimed business purposes, they are likely to have some merit and would further complicate the defense of this case.

Moreover, it is our view that in recent cases the Tax Court has resisted overturning, essentially "shamming", transactions between commonly-controlled entities that are at arm's length. Primary examples of this resistance are Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part, and remd. ___ F.2d ___ (7th Cir. 1988); Searle & Co. and

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[4]/ The court observed, at page 208, that "the so-called rental for the 2-year period was fixed at an amount to insure substantially the desired profit to Copley over this 2-year period."

Subsidiaries v. Commissioner, 88 T.C. 252 (1987), in which cases the courts upheld the transfer under section 351 of extremely valuable intangibles that had been developed by a U.S. corporation at considerable expense (that had been deducted on the taxpayer's U.S. income tax return) to a Puerto Rican subsidiary.

One of the arguments made by the IRS in Lilly was that section 482 authorizes the Commissioner to disregard the legal ownership of the intangibles and to reallocate the income attributable to the intangibles from the Puerto Rican subsidiary to the U.S. parent. See Lilly, supra, at pp. 1116-1117. In rejecting this substance over form argument, the Tax Court observed, at pages 1125-1126, that

> both the form and the substance of petitioner's transfer of assets to Lilly P.R. comported with economic reality.
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> * * *
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> Respondent's case actually is based upon his belief that because petitioner could have retained the ownership of the patents and know-how and realized all the income attributable thereto, petitioner's transfer of the ownership of the patents and know-how can be ignored for income tax purposes. That argument was rejected by this Court 40 years ago.[5/]

Similarly, the IRS relied primarily on a sham corporation theory in Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983); the court, relying on a line of cases beginning with Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), rejected this argument on the theory that a corporation that has a business purpose and actually carries on business is not a sham and is to be recognized for tax purposes. Hospital Corp. of America, supra, at page 586.

Thus, it is our view that the IRS will be unable to defend a section 482 allocation in this case that is based on the Ballentine Motor Co./Spicer Theatre, Inc. theory that the sale of the [redacted] property was primarily motivated by tax considerations (i.e., to offset [redacted]'s income tax paid in prior years and to give the group a stepped-up basis in the condominiums that would be advantageous when the units were sold). It is our view that the sale was a valid tax planning mechanism. Accordingly, we do not concur in your approval of the revenue agent's section 482 allocation in this case.

5/ The court was referring to its opinion in Seminole Flavor Co. v. Commissioner, 4 T.C. 1215 (1945).

Debt versus equity issue

You have also requested our views on the advice you gave with respect to the debt versus equity issue proposed by the revenue agent.

As noted above in footnote 2, the common parent of [redacted] and [redacted], [redacted], [redacted] loaned the latter funds to meet its obligations on the purchase money note that [redacted] gave as partial consideration on its purchase of the [redacted] property. The advances from [redacted] to [redacted] were made on [redacted] and [redacted] in the respective amounts of $[redacted] and $[redacted]. These debts, to the extent of $[redacted], were subordinated to a loan from [redacted] that eventually totaled $[redacted]. The loans by [redacted] were evidenced by promissory notes payable on demand in Deutsch Marks and bore interest at [redacted] percent per annum. The interest was paid in [redacted] ($[redacted]) and [redacted] ($[redacted]) by way of additional notes that increased the amount of the indebtedness. No interest was paid by [redacted] in [redacted] and in [redacted] [redacted] reclassified the loans as paid-in capital.

The revenue agent proposes to reclassify [redacted]s debt to [redacted] as capital contributions to the extent of $[redacted] (the amount of the advance subordinated to the bank loan to [redacted]. The result of the reclassification of the debt as a contribution to capital is disallowance of $[redacted] in interest deductions claimed by [redacted] on its returns for [redacted] and [redacted] In your memorandum to the district director, dated November 2, 1988, you do not take a position as to whether the debt versus equity issue should be set-up in this case but rather state that the revenue agent will develop the issue further and, in particular, compare the [redacted] loans to [redacted] with the loans made to [redacted] by [redacted]

The debt versus equity question is factual, and the determination turns on the particular facts of each case. See, e.g., Jones v. United States, 659 F.2d 618 (5th Cir. 1981). Appellate venue for this case would presumably be the Eleventh Circuit. In Lane v. United States, 742 F.2d 1311 (11th Cir. 1984), the Eleventh Circuit listed the following factors as being relevant to a determination of whether a shareholder advance is a debt or a contribution to capital:

(1) the names given to the certificates evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;

(6) the status of the contribution in relation to regular corporate creditors;
(7) the intent of the parties;
(8) "thin" or adequate capitalization;
(9) identity of interest between creditor and stockholder;
(10) source of interest payments;
(11) the ability of the corporation to obtain loans from outside lending institutions;
(12) the extent to which the advance was used to acquire capital assets; and
(13) the failure of the debtor to repay on the due date or to seek a postponement.

While the advances in this case were apparently evidenced by purchase money notes which would indicate debt rather than equity, the Eleventh Circuit in Lane considered this factor to be of relatively minor importance. Of somewhat more significance, and supporting taxpayers' position that the advances were debt, the notes in this case were payable on demand and had a fixed maturity date.

However, at the time the advances were made there was no clear source of funds from which [redacted] would be able to repay the advances (the market for sales of condominiums was apparently nonexistent, and it was clear that operation of the development as rental units would result in losses); therefore, the evidence indicates that repayment of the advances depended on the success of the business which is strong indication of an equity contribution. Furthermore, [redacted] made no interest payments in cash but rather gave additional notes as the interest became due, and on the due date of the loan, the principal and accrued interest balances were converted to paid-in capital. The Eleventh Circuit in Lane considered the repayment factor and the intent of the parties to be the most significant factors.

As to the intent of the parties, while the form of the notes is clear evidence of debt, it is nearly inconceivable that [redacted] had any reasonable expectation that the principal and interest would be paid when due. As pointed out above, there was no obvious source of funds in [redacted] from which [redacted] would be able to make payment on the notes. This was even clearer after [redacted] subordinated $[redacted] of its advances to the loan that [redacted] received from [redacted]. In this regard, [redacted] took no action, if it had any right to do so, to enforce payment of interest or principal from [redacted]. Furthermore, it appears that [redacted] was thinly capitalized.[6] With respect to this factor, the court in Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972), that was relied on by the Eleventh Circuit in Lane, observed that

> thin capitalization is very strong evidence of a capital contribution where (1) the debt to equity ratio was initially high, (2) the parties realized the likelihood that it would go higher, and (3) substantial portions of these funds [i.e., the advances in issue] were used for the purchase of capital assets ....

As you have advised the district director, another relevant factor is whether [redacted] could have obtained loans from unrelated sources. See, e.g., Estate of Mixon, supra; and Tomlinson v. The 1661 Corp., 377 F.2d 291 (5th Cir. 1967). While [redacted] obtained a loan for over $[redacted] from the [redacted] the bank required the nearly all of [redacted]'s obligations to [redacted] be subordinated to the bank loan, and it is possible that the bank looked more to [redacted] than to [redacted] for repayment. As you recommended, the district should further develop this matter.

The debt versus equity issue is completely factual. We cannot say that on the facts of this case that the IRS could not prevail on this issue. We think that there are significant indications that the advances from [redacted] should be characterized as contributions to capital which was what the advances were ultimately converted into.

If you have any further questions or if we can offer additional assistance, please call Ed Williams at FTS 287-4851.

/S/

GEORGE M. SELLINGER

Attachments:
Your files.

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[6] / The debt to equity ratio of [redacted] for the years in issue was as follows:

[redacted]